Accounting for Partnerships

Chapter 12

Wild and Shaw

Fundamental Accounting Principles

25th Edition

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Chapter 12 Learning Objectives

CONCEPTUAL

C1 Identify characteristics of partnerships and similar organizations.

ANALYTICAL

A1 Compute partner return on equity and use it to evaluate partnership performance.

PROCEDURAL

P1 Prepare entries for partnership formation.

P2 Allocate and record income and loss among partners.

P3 Account for the admission of partners.

P4 Account for the withdrawal of partners.

P5 Prepare entries for partnership liquidation.

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Learning Objective C1

Identify characteristics of partnerships and similar organizations.

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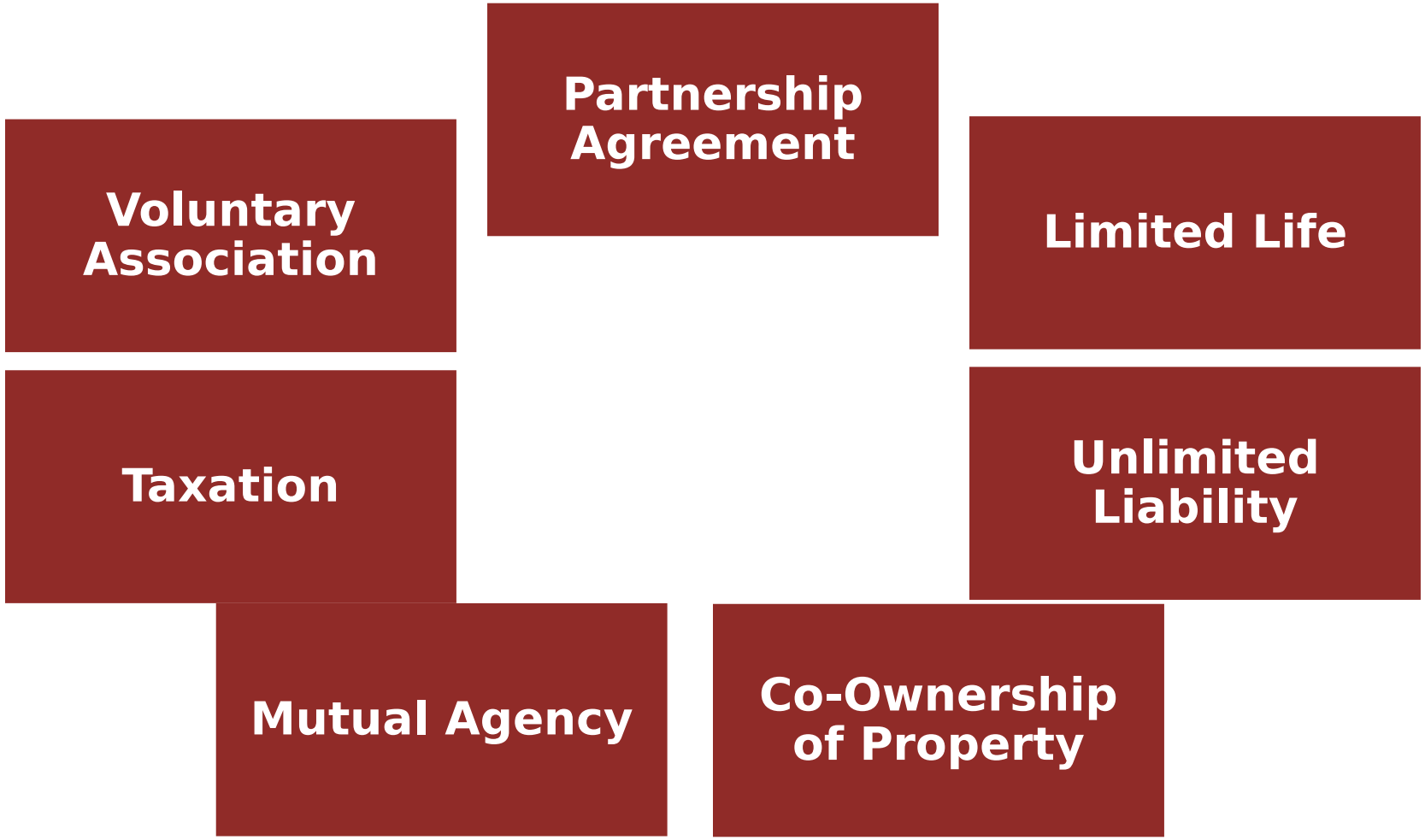
Partnership Formation



Learning Objective C1: Identify characteristics of partnerships and similar organizations.

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Organizations with Partnership Characteristics

General partnership: Entities where all partners have mutual agency and unlimited liability.

Limited Partnership:

- General partners have management duties and unlimited liability for debts.
- Limited partners have no personal liability beyond

Limited Liability Partnership:

- Protects innocent partners from malpractice or negligence claims resulting from acts of another partner.

S Corporation:

- 100 or fewer owners.
- Treated as partnership for income tax purposes.
- Same limited liability as a C

Limited Liability Company:

- Members have same limited liability as owners of a corporation .
- Income tax, treated as a partnership

Learning Objective C1: Identify characteristics of partnerships and similar organizations.

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Choosing a Business Form

	General Partnership	LP	LLP	LLC	S Corp.	C Corp.
Limited liability	No	Limited*	Yes	Yes	Yes	Yes
Business taxed	No	No	No	No	No	Yes

*General partners have unlimited liability; limited partners have limited liability.

- **Many factors should be considered when choosing the proper business form.**
- **Majority of new businesses are set up as LLC's because of tax benefits and limited liability features.**
- **Accounting for LLC's is very similar to that for partnerships.**
- **Key difference between partnerships and LLC's is in**

Learning Objective C1: Identify characteristics of partnerships and similar organizations.

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Learning Objective P1

Prepare entries for partnership formation.

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Accounting for Partnership Formation

Partners can invest both assets and liabilities in the partnership.

Assets and liabilities are recorded at market value of the contributed assets and liabilities.

Asset contributions increase the partner's capital account and withdrawals decrease partner's capital account.

Net income (or loss) is allocated to partners according to partnership agreement.

Learning Objective P1: Prepare entries for partnership formation.

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Organizing a Partnership

In accounting for partnerships:

1. Partners' withdrawals are debited to their own separate withdrawals account.
2. Partners' capital accounts are credited (or debited) for their shares of net income (or net loss) when closing the accounts at the end of the period.
3. Each partner's withdrawal account is closed to that partner's capital account. Separate capital and withdrawals accounts are kept for each

Learning Objective P1: Prepare entries for partnership formation.

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Organizing a Partnership: Journal Entries

On 1/11, Kayla Zayn and Hector Perez organize a partnership called BOARDS. Zayn's initial investment is $7,000 cash, $33,000 in boarding facilities, and a note payable for $10,000 on the boarding facilities. Perez's initial investment is $10,000

Jan. 11	Cash	7,000	
	Boarding facilities	33,000	
	Note payable		10,000
	K. Zayn, Capital		30,00
Jan. 11	Cash	10,000	
	H. Perez, Capital		10,000
	To record the investment of Perez		

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Learning Objective P2

Allocate and record income and loss among partners.

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Dividing Partnership Income or Loss

Partners are not employees of partnership but are its owners. No salaries reported as expense on the income statement. Profits or losses of the partnership are divided on some agreed upon ratio.

Three frequently used methods to divide income or loss are allocation on:

1. **Stated ratios.**
2. **Capital balances.**
3. **Salary and interest allowances and any remainder according to a fixed ratio.**

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Allocation on Stated Ratios

In the partnership agreement, Zayn is to receive 2/3 and Perez 1/3 of partnership income or loss. If the partnership income is $60,000, we will allocate the income to partners as follows:

Dec. 31	Income Summary	60,000	
	K. Zayn, Capital (⅔ × $60,000)		40,000
	H. Perez, Capital (⅓ × $60,000)		20,000
	Allocate Summa		

$60,000 × 2/3 = $40,000

$60,000 × 1/3 = $20,000

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Allocation on Capital Balances

In their partnership agreement, Zayn and Perez agree to share income and loss on the ratio of their beginning capital balances.

	Balance	Ratio	Income	Allocation
K. Zayn, Capital	$ 30,000	75%	$ 60,000	$ 45,000
H. Perez, Capital	10,000	25%	60,000	15,000
Totals	$ 40,000	100%		$ 60,000

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Allocation on Services, Capital, and Stated Ratios

Zayn and Perez have a partnership agreement with the following conditions:

1. Zayn receives a $36,000 annual salary allowance and Perez receives an allowance of $24,000.
2. Each partner is allowed an annual interest allowance of 10% on their beginning capital balance.
3. Any remaining balance of income or loss is allocated equally.

$70,000

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Allocation on Services, Capital, and Stated Ratios: Income Exceeds Allowances

	Zayn	Perez	Total
Net income			$70,000
Salary allowances			
Zayn	$ 36,000		
Perez		$ 24,000	
Interest allowances			
Zayn (10% × $30,000)	3,000		
Perez (10% × $10,000)		1,000	
Total salaries and interest	39,000	25,000	64,000
Balance of income			6,000
Balance allocated equally			
Zayn	3,000		
Perez		3,000	
Total allocated			6,000
Balance of income			$ 0
Income of each partner	$42,000	$28,000	

Exhibit 12.1

Learning Objective P2: Allocate and record income and loss among partners.

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Allocation on Services, Capital, and Stated Ratios: Allowances Exceed Income

	Zayn	Perez	Total
Net income			$50,000
Salary allowances			
Zayn	$ 36,000		
Perez		$ 24,000	
Interest allowances			
Zayn (10% × $30,000)	3,000		
Perez (10% × $10,000)		1,000	
Total salaries and interest	39,000	25,000	64,000
Balance of income			(14,000)
Balance allocated equally			
Zayn	(7,000)		
Perez		(7,000)	
Total allocated			(14,000)
Balance of income			$ 0
Income of each partner	$32,000	$18,000	

Exhibit 12.2

Learning Objective P2: Allocate and record income and loss among partners.

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Partnership Financial Statements

During 2021, Zayn withdrew $20,000 cash from the partnership and Perez withdrew $12,000. Net income is $70,000.

BOARDS
Statement of Partners' Equity
For Year Ended December 31, 2021

	Zayn		Perez		Total
Beginning capital balances		$ 0		$ 0	$ 0
Plus					
Investments by owners		30,000		10,000	40,000
Net income					
Salary allowances	$36,000		$24,000		
Interest allowances	3,000		1,000		
Balance allocated	3,000		3,000		
Total net income		42,000		28,000	70,000
		72,000		38,000	110,000
Less partners' withdrawals		(20,000)		(12,000)	(32,000)
Ending capital balances		$52,000		$26,000	$78,000

Exhibit 12.3

Learning Objective P2: Allocate and record income and loss among partners.

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Learning Objective P3

Account for the admission of partners.

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Admission of a Partner

When the makeup of the partnership changes, the existing partnership is dissolved.

A new partnership may be immediately formed.

New partner acquires partnership interest by:

1. Purchasing it from the other partners, or
2. Investing assets in the partnership.

Learning Objective P3: Account for the admission of partners.

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Purchase of Partnership Interest

- **A new partner can purchase partnership interest directly from the existing partners.**
- **The cash goes to the partners, not to the partnership.**

Learning Objective P3: Account for the admission of partners.

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Purchase of Partnership Interest: Illustration

On January 4th, Hector Perez sells one-half of his partnership interest to Tyrell Rasheed for $18,000. Perez gives up a $13,000 recorded interest in the partnership.

	Zayn	Perez	Rasheed	Total
Capital balances before new partner	$ 52,000	$ 26,000	$ -	$ 78,000
Allocation to new partner		(13,000	13,000	-

Jan. 4	H. Perez, Capital	13,000	
	T. Rasheed, Capital		13,000
	Record admission of Rasheed by purchase.		

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Investing Assets in a Partnership

- The new partner can gain partnership interest by contributing assets to the partnership.
- The new assets will increase the partnership's net assets.
- After admission, both assets and equity will increase.

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Investing Assets in a Partnership: Illustration

On January 4th, Tyrell Rasheed is admitted to the partnership with a payment of $22,000 cash.

	Zayn	Perez	Rasheed	Total
Capital balances before new partner	$ 52,000	$ 26,000	$ -	$ 78,000
Allocation to new partner			22,000	22,000
Capital balances after new	$	$	$	$

Jan. 4	Cash	22,000	
	T. Rasheed, Capital		22,000
	Record admission of Rasheed by investment.		

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Bonus to Old or New Partners

Bonus to Old Partners

When the current value of a partnership is greater than the recorded amounts of equity, the old partners usually require a new partner to pay a

Bonus to New Partners

The partnership may grant a bonus to a new partner if the business is in need of cash or if the new partner has exceptional talents.

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Bonus to Old Partners[1]

On January 4th, Zayn and Perez agree to accept Rasheed as a partner upon his investment of $42,000 cash in the partnership. Rasheed is to receive a 25% ownership interest in the new partnership. Any bonus is attributable to the existing partners and is shared equally.

Equity of Zayn and Perez	**$ 78,000**
Investment by Rasheed	**42,000**
Total partnership equity	**1,20,000**
Rasheed's ownership percent	**25%**
Rasheed's equity balance	**$ 30,000**

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Bonus to Old Partners 2

On January 4th, Zayn and Perez agree to accept Rasheed as a partner upon his investment of $42,000 cash in the partnership. Rasheed is to receive a 25% ownership interest in the new partnership. Any bonus is attributable to the existing partners and is shared

Jan. 4	Cash	42,000	
	T. Rasheed, Capital		30,000
	K. Zayn, Capital ($12,000 × ½)		6,000
	H. Perez, Capital ($12,000 × ½)		6,000
	To record admission of Rasheed and		

$42,000 − $30,000 = $12,000 × ½ = $6,000

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Bonus to New Partner

On January 4th, Zayn and Perez agree to accept Rasheed as a partner upon his investment of $18,000 cash in the partnership. Rasheed is to receive a 25% ownership interest in the new partnership. Any bonus is attributable to Rasheed's excellent business skills.

Equity of Zayn and Perez	**$ 78,000**
Investment by Rasheed	**18,000**
Total partnership equity	**96,000**
Rasheed's ownership percent	**25%**
Rasheed's equity balance	**$ 24,000**

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Bonus to New Partner: Journal Entry

On January 4th, Zayn and Perez agree to accept Rasheed as a partner upon his investment of $18,000 cash in the partnership. Rasheed is to receive a 25% ownership interest in the new partnership. Any bonus is attributable to Rasheed's excellent business skills.

Jan. 4	Cash	18,000	
	K. Zayn, Capital ($6,000 × ½)	3,000	
	H. Perez, Capital ($6,000 × ½)	3,000	
	T. Rasheed, Capital		24,000
	To record Rasheed's admission and bonu		

$18,000 − $24,000 = $(6,000) × ½ = $(3,000)

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Learning Objective P4

Account for the withdrawal of partners.

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Withdrawal of a Partner

A partner can withdraw in two ways:

1. **The partner can sell his/her partnership interest to another person.**
2. **The partnership can distribute cash and/or other assets to the withdrawing partner.**

Learning Objective P4: Account for the withdrawal of partners.

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Withdrawal of a Partner – No Bonus

At the date of the withdrawal of Perez, the partners have the following capital balances: Perez - $38,000, Zayn - $84,000, and Rasheed - $38,000. The partners share income and loss equally. Perez is to receive $38,000 cash upon

Oct. 31	H. Perez, Capital	38,000	
	Cash		38,000
	To record withdrawal of Perez from partnership with no bonus.		

Learning Objective P4: Account for the withdrawal of partners.

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Withdrawal of a Partner – Bonus to Remaining Partners

At the date of the withdrawal of Perez, the partners have the following capital balances: Perez - $38,000, Zayn - $84,000, and Rasheed - $38,000. The partners share income and loss equally. Perez is to receive $34,000 cash

Oct. 31	H. Perez, Capital	38,000	
	Cash		34,000
	K. Zayn, Capital		2,000
	T. Rasheed, Capital		2,000
	To record withdrawal of Perez and bonus to remaining partners.		

	$
Capital balance	38,000
Cash settlement	34,000
Bonus	4,000
Times	50%

Learning Objective P4: Account for the withdrawal of partners.

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Withdrawal of a Partner – Bonus to Withdrawing Partner

At the date of the withdrawal of Perez, the partners have the following capital balances: Perez - $38,000, Zayn - $84,000, and Rasheed - $38,000. The partners share income and loss equally. Perez is to receive $40,000 cash

Oct. 31	H. Perez, Capital	38,000	
	K. Zayn, Capital	1,000	
	T. Rasheed, Capital	1,000	
	Cash		40,000
	To record Perez's withdrawal from partnership with a bonus to Perez.		

	$
Capital balance	38,000
Cash settlement	40,000
Deficiency	2,000
Times	50%

Learning Objective P4: Account for the withdrawal of partners.

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Death of a Partner

A partner's death dissolves a partnership. A deceased partner's estate is entitled to receive his or her equity. The partnership agreement should contain provisions for settlement. These provisions usually require:

1. Closing the books to determine income or loss since the end of the previous period, and
2. Determining and recording current market values for both assets and liabilities.

Settlement of the deceased partner's estate can involve selling the equity to remaining partners or to an outsider, or it can involve withdrawal of assets.

Learning Objective P4: Account for the withdrawal of partners.

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Learning Objective P5

Prepare entries for partnership liquidation.

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Liquidation of a Partnership

A partnership dissolution requires 3 steps:

1. Gain or loss on liquidation is allocated to partners using their income-and-loss agreement.
2. Pay all partner liabilities.
3. Distribute any remaining cash to partners based on their capital balances.

Learning Objective P5: Prepare entries for partnership liquidation.

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No Capital Deficiency

No capital deficiency means that all partners have a zero or credit balance in their capital accounts.

Zayn, Perez, and Rasheed agree to dissolve their partnership. The only outstanding liability is an account payable of $20,000. Prior to dissolution the partnership has the following balance sheet:

Cash	$178,000	Accounts Payable	$20,000	H. Perez, Capital	$66,000
Land	40,000	K. Zayn, Capital	70,000	T. Rasheed, Capital	62,000

Learning Objective P5: Prepare entries for partnership liquidation.

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No Capital Deficiency: Step 1

BOARDS begins the dissolution process by selling the land for $46,000 cash. The gain on the sale of the land is distributed equally among the partners. After the sale of the land the company pays the account payable.

Jan. 15	Cash	46,000	
	Land		40,000
	Gain from Liquidation		6,000
Jan. 15	Gain from Liquidation	6,000	
	K. Zayn, Capital		2,000
	H. Perez, Capital		2,000
	T. Rasheed, Capital		2,000
	To allocate liquidation gain to partners.		

Learning
liquidation.

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No Capital Deficiency: Steps 2 and 3

Jan. 15	Accounts Payable	20,000	
	Cash		20,000

After step 2, we have the following capital balances along with the remaining cash balance.

K. Zayn, Capital		
	Bal.	70,000
	(b)	2,000
	Bal.	72,000

H. Perez, Capital		
	Bal.	66,000
	(b)	2,000
	Bal.	68,000

T. Rasheed, Capital		
	Bal.	62,000
	(b)	2,000
	Bal.	64,000

Cash				
Bal.	178,000		(c)	20,000
(a)	46,000			
Bal.	204,000			

Jan. 15	K. Zayn, Capital	72,000	
	H. Perez, Capital	68,000	
	T. Rasheed, Capital	64,000	
	Cash		204,000
	To distribute remaining cash to partners.		

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Capital Deficiency

- Capital deficiency means that a partner has a debit balance in his or her capital account at the point of final cash distribution.
- This can arise from liquidation losses, withdrawals before liquidation, or recurring losses in prior periods.
- A partner with a capital deficiency must pay cash into the partnership.

Learning Objective P5: Prepare entries for partnership liquidation.

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Partner Pays Deficiency

Zayn, Perez, and Rasheed agree to dissolve their partnership.
Prior to the final distribution of cash to the partners, Zayn has a capital balance of $19,000, Perez $8,000, and Rasheed $(3,000). Rasheed owes the partnership $3,000

Jan. 15	Cash	3,000	
	T. Rasheed, Capital		3,000
	To record payment of deficiency by Rasheed		
Jan. 15	K. Zayn, Capital	19,000	
	H. Perez, Capital	8,000	
	Cash		27,000
	To distribute remaining cash to partners.		

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Partner Cannot Pay Deficiency

Let's use the information from our previous example of a capital deficiency and assume partners divide profit and losses equally.

	Zayn	Perez	Rasheed	Total
Ending capital balances	**$ 19,000**	**$ 8,000**	**$ (3,000)**	**$ 24,000**

Jan. 15	K. Zayn, Capital	1,500	
	H. Perez, Capital	1,500	
	T. Rasheed, Capital		3,000
	To transfer Rasheed deficiency to Zayn		
Jan. 15	K. Zayn, Capital	17,500	
	H. Perez, Capital	6,500	
	Cash		24,000
	To distribute remaining cash to partners		

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Learning Objective A1

Compute partner return on equity and use it to evaluate partnership performance.

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Partner Return on Equity

$$\text{Partner return on equity} = \frac{\text{Partner net income}}{\text{Average partner equity}}$$

Exhibit 12.4

$ thousands	Total*	Boston Celtics LP I	Boston Celtics LP II	Celtics LP
Beginning-year balance	$ 85	$122	$(307)	$270
Net income (loss) for year	216	44	61	111
Cash distribution	___	___-___	___-___	___
*Totals may not add up due to rounding.				
Ending-year balance	___	___$166___	___$(246)___	___$333___
Partner equity	**___%**	**30.6%**	**n.a.**	**36.8%**

216/[(85 + 253)/2] = 127.8%

Learning Objective A1: Compute partner return on equity and use it to evaluate partnership performance.

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End of Chapter 12

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